The Entrepreneur As American Hero

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The following remarks were delivered on February 6, 2005, on the Hillsdale College campus, during a seminar on "Entrepreneurship and the Spirit of America," co-sponsored by the Center for Constructive Alternatives and the Ludwig von Mises Lecture Series.

Let's start off talking about the entrepreneur with a brief discussion of the sources of income. Some of the rhetoric one hears gives the impression that income is somehow distributed – that there's a dealer of dollars. Thus, one might think that the reason some Americans have more income than others is that the dollar dealer is a racist, a sexist or a multi-nationalist who deals out dollars unfairly. Alternatively, some suggest that the reason that some Americans are richer than others is because they got to the pile of money first and took an unfair share. In either case, justice requires that government take the ill-gotten gains of the few and restore them to their rightful owners – in other words, redistribute income. While no one actually describes the sources of income this way, the logic of their arguments for redistribution implies such a vision.

In truth, in a free society, income is earned through pleasing and serving one's fellow man. I mow your lawn, repair your roof or teach your kid economics. In turn you give me dollars. We can think of dollars as certificates of performance. With these certificates of performance in hand, I go to my grocer and ask him to give me a pound of steak and a six-pack of beer that my fellow man produced. In effect the grocer says, "You're making a claim on something your fellow man produced. You're asking him to serve you – but did you serve him?" I say, "Yes I did." The grocer responds, "Prove it!" That's when I show him my certificates of performance – namely, the money my fellow man paid me to mow his lawn.

Contrast the morality of having to serve one's fellow man as a condition of being served by him with the alternative. Government can say to me, "Williams, you don't have to serve your fellow man in order to have a claim on what he produces. As long as you're loyal to us, we will take what your fellow man produces and give it to you."

Obviously, some people are more effective at serving and pleasing their fellow man than others. They earn a greater number of certificates of performance (i.e., higher income) and hence have greater claims on what their fellow man produces. Take Luciano Pavarotti. Why is his income much higher than mine? It's because of discriminating people like you. You will plunk down $75 to hear him sing an aria from La Boheme; but how much would you be willing to pay to hear me do the same? Those who would call Pavarotti's income unfair and would have government take part of it to give to others are essentially saying, "We disagree with the decisions of millions upon millions of people acting voluntarily that resulted in Pavarotti's higher income. We are going to use the coercive powers of government to cancel out the full effect of those decisions through income redistribution." I might add that income redistribution is simply a legal version of what a thief does – namely, take the rightful property of one person for the benefit of another. The primary distinction between his behavior and that of Congress is legality.

For the most part, in a free society, people who are wealthy have become so through effectively serving their fellow man. Cyrus McCormick and his reaping machine, Thomas Watson Sr., the founder of IBM, and Lloyd Conover, who created the antibiotic tetracycline in the employ of Pfizer Company are just a few of the exceptional contributors. And while these people and their companies became extremely wealthy, society benefitted far more than they did in terms of the value of healthier lives and the millions and possibly billions of lives saved.

Capitalism Raises All Boats

Propaganda and stubborn ignorance has it that the advances of capitalism benefit only the rich. The evidence, as I've already pointed out, refutes that. Let's look at more: The rich have always been able to afford entertainment, but it was the development and marketing of radio and television that made entertainment accessible to the common man. The rich have never had the drudgery of washing and ironing clothing, beating out carpets or waxing floors. It was the development and mass production of washing machines, wash and wear clothing, vacuum cleaners and no-wax floors that spared the common man of this drudgery. At one time, only the rich could afford automobiles, telephones and computers. Now all but a tiny percentage of Americans enjoy these goods.

Today, as it has always been, the direct impetus for technological innovation and progress has been the entrepreneurial search for profits and the competitive economy. As

Stephen Moore and Julian L. Simon point out in their 1999 article, “The Greatest Century That Ever Was,” over the course of the 20th century life expectancy rose from 47 to 77 years of age; deaths from infectious disease fell from 700 to 50 per 100,000 of the population; agricultural workers fell from 35 to 2.5 percent of the workforce; auto ownership rose from one to 91 percent of the population; and patents granted rose from 25,000 to 150,000 a year. Controlling for inflation, household assets rose from $6 trillion to $41 trillion between 1945 and 1998.

Let’s consider another factor that is nearly completely ignored. The output and wealth generated through free enterprise contributes to a more civilized society. For most of mankind’s existence, he has had to spend most of his time simply eking out a living. In pre-industrial society and in many places in the world still today, the most optimistic scenario for the ordinary citizen was to be able to eke out enough to meet his physical needs for another day. But with the rise of capitalism and the concomitant rise in human productivity that yielded seemingly ceaseless economic progress, it was no longer necessary for mankind to spend his entire day simply providing for minimum physical needs. People were able to satisfy their physical needs with less and less time. This made it possible for them to have the time and resources to develop spiritually and culturally.

In other words, the rise of capitalism enabled the gradual extension of civilization to greater and greater numbers of people. More of them have time available to read, become educated in the liberal arts and gain more knowledge about the world around them. Greater wealth permits them to attend the arts, afford recreation, contemplate more fulfilling and interesting life activities and enjoy other culturally enriching activities that were formerly within the purview of only the rich. How was all this achieved? In a market system, enterprise profits are performance-related; they come about through a process of finding out what human wants are not being met and finding ways to meet them.

In reference to the motivations of the entrepreneur, Adam Smith says this: “By directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention.” That might very well describe an entrepreneur like Thomas Watson Sr., founder of IBM. Such previously unimaginable progress as we have seen in recent decades is the direct result of having methods of handling large amounts of data accurately and rapidly. From the 1930s onward, IBM was at the forefront in the development of the machinery to do this. The huge benefits we enjoy as a result of IBM’s pioneering work was no part of the intention of Thomas Watson or his successors. They were in it for profits.

In Defense of Profit

Profit has almost become a dirty word, so let me spend a few minutes talking about the magnitude of profits and the role that they play in a free market economy. Regarding their magnitude, only roughly six cents of each dollar companies take in represent after-tax profits. By far, wages are the largest part of that dollar, representing about 60 cents.

As percentages of 2002 national income, after-tax profits represented about five percent and wages about 71 percent.

I'll discuss first what might be called normal profit and later turn to the more emotional topic of "windfall profits" – what some have labeled "obscene profits." Normal profit is the opportunity cost of using entrepreneurial abilities in the production of a good. It's what the entrepreneur could have earned in his next best alternative – say, another business venture. Just as wages, rent and interest must be paid in order to employ the services of labor, land and capital, normal profits must be paid to employ entrepreneurial services – the decisions, innovations and risks that drive economic progress.

Whether an entrepreneur makes a profit depends essentially on two things. The first is whether he is producing a good that consumers value and are willing to pay for; the second is whether he's using the scarce resources of society in the most efficient manner to produce the good.

Let's look at an example of the role of profits in providing incentives to produce what the consumer wants. Remember when Coca Cola introduced the "new" Coke in 1985? Pepsi Cola president Roger Enrico called it "the Edsel of the '80s," representing one of that decade's greatest marketing debacles. Who made the Coca Cola Company bring back the old Coke? Was it Congress, the courts, the president or other government officials acting in the interests of soda-drinking Americans? No, it was the specter of negative profits (i.e., losses) that convinced Coca Cola to bring back the old Coke. Thus, one role of profits is to discover what consumers want and to correct producers who make mistakes.

Profits also force producers to employ resources wisely. If producers waste inputs, their production costs will be higher. In order to cover their costs, they must charge prices higher than what consumers are willing to pay. After a while the company will incur unsustainable losses and go out of business. As a result, the company's resources will become available to someone else who'll put them to wiser use. This process is short-circuited if government offers bailouts in the forms of guaranteed loans, subsidies or restrictions such as tariffs and import quotas on competitive products from abroad. Government "help" enables failing companies to continue squandering resources. In this context it is important to remember that a business going bankrupt doesn't meant that its productive resources will vanish into thin air. It means someone else will own them.

So-called windfall profits are profits above and beyond those needed to keep an entrepreneur producing a good or service. But they serve a vital social function. They serve as a signal that there are unmet human wants. One of the best examples of the role of windfall profits are those that arise in the wake of a disaster and are often condemned as price gouging. In the wake of a disaster, such as a hurricane, there is an immediate change in scarcity conditions that's reflected in higher prices for goods and services. Assume, for example, that a family of four sees their home damaged or destroyed. At before-disaster prices, they might decide to rent two adjoining hotel rooms. However, when they arrive at the hotel and see that room prices have doubled, they might easily decide to tough it out in a single room. Doing so makes a room available for someone else whose home was damaged and who needs a place to spend the night. Thus, higher prices give people an incentive to economize on scarce resources.

In the wake of Florida's Hurricane Andrew, windfall profits played a vital though unappreciated role. Plywood destined to be shipped to the Midwest, West and Northeast suddenly was rerouted to South Florida. Lumber mills increased production. Truckers and other workers worked overtime in order to increase the availability of plywood and other construction materials to Floridians. Rising plywood prices meant something else as well. All that plywood heading south meant plywood prices rose in other locations, discouraging "lower valued" uses of plywood such as home improvement projects. After all, rebuilding and repairing destroyed homes is a "higher valued" use of plywood.

What caused these market participants to do what was in the social interest, namely, sacrifice or postpone alternative uses for plywood? The answer reveals perhaps the most wonderful feature of this process. Rising prices and opportunities for higher profits encouraged people to do voluntarily what was in the social interest: help their fellow man recover from a disaster.

Williams' Law

At this juncture let me say a few words about the modern push for corporate social responsibility. Do corporations have a social responsibility? Yes, and Nobel Laureate Professor Milton Friedman put it best in 1970 when he said that in a free society "there is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud."

It is only people, not businesses, who have responsibilities. A CEO is an employee, an employee of shareholders and customers. The failure of the corporate executive community to recognize this, and its willingness to engage in activities unrelated to the pursuit of profits, means national wealth will be lower, product prices will be higher and the return on investment lower.

If we care about people's wants, rather than beating up on profit-making enterprises, we should pay more attention to government-owned non-profit organizations. A good example are government schools. Many squander resources and produce a shoddy product while administrators, teachers and staff earn higher pay and perks, and customers (taxpayers) are increasingly burdened. Unlike other producers, educationists don't face the rigors of the profit discipline, and hence they're not as accountable. Ditto the U.S. Postal Service. It often provides shoddy and surly services, but its managers and workers receive increasingly higher wages while customers pay higher and higher prices. Again, wishes of customers can be safely ignored because there's no bottom line discipline of profits.

Here's Williams' law: Whenever the profit incentive is missing, the probability that people's wants can be safely ignored is the greatest. If a poll were taken asking people which services they are most satisfied with and which they are most dissatisfied with, for-profit organizations (supermarkets, computer companies and video stores) would dominate the first list while non-profit organizations (schools, offices of motor vehicle registration) would dominate the latter. In a free economy, the pursuit of profits and serving people are one and the same. No one argues that the free enterprise system is perfect, but it’s the closest we’ll come here on Earth.